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Ethical Lending - Ethical Legislation

Residential property
Foreign currency-based lending
Loan types
Foreign currency legislation

1. What makes this topic relevant

Hungarian society has never been keen on borrowing. It is partly due to the fact that lending was also centralised as a state monopoly in the period of socialism. Commercial banks and lending practically ceased to exist. As there was neither private property nor lending, there was no need for collateral either. Older generations continue to remember vividly the period before World War II, when almost all families were hit by the collapse of the economy and hyperinflation of the 1920s. Family stories still recall ancestors who pledged their homes and land but were unable to repay loans and the rest of the family had to try and make the repayments. Also, rural communities and especially people in villages look at borrowing as something shameful even today.

One may at the same time ascertain, however, *the special role residential property plays in the Hungarian population.* That is so because, due to the shocks experienced during history, real property which, by the legacy of what used to be an archaic rural society, continues to be associated with the title to arable land and to one's home, has become especially important in the Hungarian society. Title to real property is also closely related to the civilian ideals which suggests it is an asset that must be preserved and also enriched.

As a property item, residential property is characterised by the need to refurbish completely or to replace, which recurs once every generation. Given the size of the population and of families in Hungary, 40,000 new homes should be built each year, on average. After the 1980s, that target was first achieved during the first Orbán government. The interest subsidised HUF housing loan scheme introduced by the first Orbán government was the first successful attempt that, in addition to increasing the volume of home construction, encouraged young couples to move into modern homes of their own.

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As a result, the number of newly constructed homes increased gradually from 1999.

Following the parliamentary elections in 2002, the new government abolished interest rate subsidisation with reference to fiscal considerations. However, people's desire to own a home has remained. HUF-based housing loans could not be maintained without interest rate subsidisation by the state because the HUF base rate of 8-12% coupled with 14-18% market lending rates at that time.

As the HUF interest rate was extremely high, an idea emerged to replace the denomination of retail loans with foreign currencies that had lower lending rates. High inflation, which refused to subside permanently, and the high base interest rate also veered households towards currency loans due to the high interest rate spread. It was at that time that housing loans denominated in foreign currencies, primarily CHF, were first offered at low rates of interest in the Hungarian market. Bearing lower interest rates, these foreign currency-based housing loans involved lower interest payments. The repayment schedule of the foreign currency loans was more favourable in that repayments started with smaller amounts, hence borrowers had to pay less in the initial period than in the case of HUF loans.

By the beginning of the 2010s, the portfolio of FX denominate retail loans became a factor impeding the development of the economy due to its size and the related risk factors. Consequently, the legislator was forced to take action. In the end, FX denominated retail loans were banned in 2010, but that did not resolve the problem at all. That is clearly illustrated by the size of the retail portfolio of FX loans which surpassed HUF 4,147 billion (EUR 13,8 million) at the end of June 2014 four years after FX lending was prohibited by law. In total therefore approximately 872,000 consumer FX loan agreements were still in place the end of the first half of 2014.

The review of the history of foreign currency loans in Hungary raises the issue as to whether ethical lending exists at all. The answer to that question requires a more detailed examination of the role of lending in present-day modern economy.

2. Role and forms of lending

2.1. *The role of lending in present-day modern economy*

No capitalist economy could have developed without the large surge of lending. Granting credit becoming a general phenomenon in the economy as a whole is one of the inherent features of capitalism which brought with it the emergence and the acceptance by society of loan liabilities and debts. That had far reaching economic, social and psychological consequences.

The process coupled closely with the commercialisation of *almost all assets, which transformed into goods.* In that respect, it was a major factor in all societies that real property assets, primarily *land, also took on the characteristics of goods.* All feudal restrictions were lifted from land, as it became subject matter of market trading and the financing of land purchases with loans was also introduced. Nowadays, some economists believe that the elimination of feudal restrictions and the transformation of land into a commodity led to more negative consequences than advantages.

However, the situation was different during the earlier periods of the history of civilisation. *In former times credit relationships did not exist, only immediate payments were known.* Most archaic economies that preceded capitalism lacked pricing markets, which were quite frequently substituted by price setting. Similarly, *there was no credit either because the markets that could have transferred the impact of transactions across markets had not yet developed either.* Such an economy is described clearly by *Károly Polányi* in his work dedicated to the economic performance of the West African Kingdom of Dahomey in the 18th century.

The period of socialist planned economy may be selected from recent Hungarian history as an attempt at eliminating lending from the operation of the economy. A state lending monopoly was introduced, lending disappeared from the relations between economic organisations and retail lending was also reduced considerably.

As that attempt failed, it is not yet clear under the current circumstances whether or not there is any alternative to capitalism and to general lending.

2.2. *Concept and types of loans*

Economic theory defines a loan as the temporary transfer of purchasing power. This transfer is temporary since borrowers must return the purchasing power they received to the creditor after a certain period of time. In economic terms, a loan is a tool which, in an ideal case, can prevent any outage in usage.

Businesses apply for loans when their own funds are insufficient to finance required investments or maintain solvency. In certain cases, however, financing from owner's equity may also be more expensive than financing from a loan for one reason or another (e.g., due to taxation or risk distribution considerations). These days the development of production and the distribution of goods is based on debt financing raised by the entrepreneur. If that debt financing is raised through the foundation of a partnership, a business association or a co-operative, the lender will become a partner in the enterprise.

However, very often entrepreneurs raise the capital required for the development of their businesses by taking out loans. In this respect, Hungarian legal literature prior to 1945 recognised clearly that the most advanced periods of money and credit economy are characterised by production, distribution of goods and consumption relying predominantly on the use of credit, especially loans.

For the creditor extending a loan is an investment. In economic terms, it may involve cash or scriptural money lent, but it may also involve the deferral of payment. That

is to say, a loan may be provided through various actions. These different types of loan provision can be classified into two main categories: payment type loans and liability type loans.

In the case of a payment type loan an actual lending transaction is concluded, whereby the lender either provides a specific sum to the borrower or one party performs its own service sooner or grants deferral for the payment of consideration. There are various sub-types within this category. Apart from a cash loan, the payment type loans include favour loans and commodity credit (a loan provided in the form of goods also known as commercial credit) as well as securities lending. They differ not only in terms of economic importance and value, but also in terms of legal nature, form, terms and warranty consequences compared to those pertaining to a traditional loan of money.

Alternatively, the lender of a liability type loan makes a promise to perform an obligation (typically repayment) on behalf of the borrower towards a third party. Liability type loans include, for instance, sureties or guarantees (they are also known as aval loans). This category, however, also includes the discounting of bills when a lender undertakes to accept a bill issued by the borrower for a specific limited amount.

The conditions of lending and the establishment of collaterals differ substantially for each type of credit.

2.3. *Ethical lending?*

Judging from the perspective of the global financial crisis of 2008 and the almost unbelievable volume of retail FX denominated lending in Hungary, one may conclude that even lending cannot function without effective state oversight. Increasing the degree of state intervention in the economy and, indirectly in contractual relationships has always been associated with crises in the 20th century (world war, global economic crisis).

The most recent experiences relating to Hungarian and global crises suggest that the degree of state control must be strengthened over lending in general. Attempts should also be made to prevent the launch on the market of sham securities disguised as investment instruments that have no coverage at all. Unfortunately, this expectation is not yet formulated with sufficient force in the draft securitisation regulation published by the European Commission recently, which also limits the room for manoeuvre of the Hungarian legislator.

Nevertheless, it now seems clear that ethical lending can hardly be envisaged without more pronounced state intervention, which the free market cannot be expected to develop and sustain in the long run. Hence, ethical lending requires ethical legislation. As to whether it can be achieved, we wish to quote the legal regulations adopted in 2014 to manage foreign currency lending in Hungary.

3. Ethical Legislation

The traditional neoclassic school of legal economic analyses uses the examination of transaction costs as a premise as suggested by the works of *Ronald H. Coase.* Accordingly, legal economic analyses focus on the impact of a particular legal norm and judicial decision on the transaction costs and indirectly on social welfare. Viewed from any economic perspective, law is effective when it contributes to the reduction of transaction costs and promotes co-operation by doing so.

We are fully aware by now that granting exclusivity to the concept of efficiency also entails numerous risks in law, as the application of law may bring a legal norm into conflict with the values that it should convey. The analysis of efficiency is important in the course of the analysis of various legal institutions and legal norms, but it may not be exclusive. Although an efficiency driven economic review of legal norms may find answers to important issues, the legislator must also take into account other legal and political principles, including *inter alia* equity, as one of the most important principles, which, unfortunately, has been swept aside in recent decades.

Ethical content was an especially emphatic issue raised in connection with one of the major legislative acts of the past two decades, i.e., the acceptance of the foreign exchange laws. What makes these legal regulations, primarily the act on settlement, extremely important is that asset transfer of a similar scale has occurred only once in Hungarian society since the fall of communism in relation to compensation. However, compensation involved, on the one hand, the state providing assets to its citizens and, on the other hand, it was implemented through an extremely complicated mechanism. As opposed to that, approximately HUF 1,000-1,200 billion (roughly EUR 3,3 - 4 million) worth of assets were returned to private individuals from financial sector participants during the settlement of unfair foreign currency loans. This transfer of assets of such a scale is unprecedented in the Hungary history.

Act XXXVIII of 2014 on the Settlement of Certain Issues Relating to the Uniformity Decision of the Supreme Court on consumer loan agreements of financial institutions was the first component in the legislative package on foreign currency loans. The main purpose of this Act was to ensure that the provisions of the Supreme Court's uniformity decision No. 2/2014 apply to all foreign currency debtors without the need to start an individual lawsuit. This legislation helped avoid hundreds of thousands of lawsuits by declaring, with general effect, the exchange rate margin applied on the exchange rates of different currencies null and void. Another important provision of the act was the challengeable assumption of the unfair nature of any contract provision that involved an option of unilateral contract amendment. It is important to stress that in its decision No. 34/2014. (XI. 14.) AB the Constitutional Court declared the first act on foreign currency loans to be in compliance with the Fundamental Law.

The ethically important provisions of the Settlement Act are the ones that relate to the repayment of amounts unfairly taken from consumers by financial institutions.

The HUF Conversion Act was drafted in close correlation with the first two legal acts. It provided that any amounts receivable under outstanding foreign currency denominated -based consumer loan agreements shall be converted to Hungarian Forints in order to maintain the country's financial stability and eliminate the exchange rate risk of consumers. Although in this case the legislator interfered with the content of existing contracts, that intervention was in full compliance with the constitutional principle of *clausula rebus sic stantibus* and the requirement laid down in the Constitutional Court Decision No. 8/2014. (III. 20.) AB.

Finally, we must highlight the amendments of Act CLXII. of 2009 on consumer loans, which quashed the right of banks to amend contracts unilaterally and defined the future framework under which provisions concerning interest rates, fees and costs may be modified in consumer loan agreements.

The objective would be to adopt more economically sound future legal acts that can simultaneously satisfy the requirements of both equity and ethos.

4. Literature

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THE FAIRNESS OF VALUE ADDED TAX

Keywords: value added tax, tax system, fairness, tax burden, consumption tax

1. Introduction

Each country establishes its own tax regime in accordance with the unique financial needs and traditional principles thereof. There are no definitive and mandatory models, not a single one could be drawn up either. The societies obviously differ regarding their level of development; economic, legal and tax structures; experience and capacity in VAT administration; and the level of literacy.

Generally speaking it must be admitted that, even concerning taxation, supranational consensus can be found only regarding a few legal principles. Therefore it is understandable that it is hard to achieve international unity on the field of tax law and taxation systems or certain provisions thereof. Generally speaking it must be admitted that, even concerning taxation, supranational consensus can be found only regarding a few legal principles. Therefore it is understandable that it is hard to achieve international unity on the field of tax law and taxation systems or certain provisions thereof. Consequently, a design feature that works well in one country might not work in another. As Bird points out, No-One-Size-Fits-All model applies, but certain common features can be found through comparison of the common design features of the VATs in different countries in the context of their legal, economic and tax structures. Thus similarities and common lessons can be drawn up in a much higher proportion than for instance in relation to income taxes.

The simplest, but politically the most sensible way of increasing revenue would obviously be to increase the rates of existing taxes, if, among ideal conditions, taxpayers and undertakings would simply pay the higher amount. Little new legislation is needed and the administration is already in place. The aim of increasing government revenue can be achieved on the ground of fairness, efficiency, simplicity and transparency by a carefully designed VAT. It is obvious that with the method of any consumption tax, the taxpayer has a wider spectrum of decisions regarding the allocation of the income thereof. In other words, when consumption tax (e.g. value added tax) is levied, the

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